

Crowd Behaviour - Outwitting the Masses

“To achieve superior investment results, you have to hold nonconsensus views regarding value, and they have to be accurate”

- **Howard Marks, Oaktree Capital**

Think about what it means to capture a market inefficiency. There's something wrong with the market prices and behaviour, you take advantage of it before someone else.

By doing this, you are aiming to beat the market average returns (market average is loosely defined as buying and holding exposure to a US stock index). If we want market average performance, you are better off buying and holding a US stock ETF¹.

Thus, to beat the market, you need to think differently from others and/or be faster than others. In order to do that, you need to have second-order thinking.

Loose definition of second-order thinking in finance:

To think one step ahead of the pack

Examples

First-order thinking: A drought wiped out half the coffee farms in the world. Buy coffee futures!

Second-order thinking: A drought wiped out half the coffee farms in the world. Everyone is buying coffee futures! It is overbought. Sell coffee futures!

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First-order thinking: I managed to create an algorithm to predict a company's quarterly earnings. Buy the stocks when the predicted earnings are high.

Second-order thinking: I managed to create an algorithm to predict a company's quarterly earnings. Buy the stocks when the predicted earnings are higher or predicted losses are lower than analysts' expectations.

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First-order thinking: I see a trend in EURUSD! Long EURUSD!

Second-order thinking: Past trends alone do not predict the future in FX. The market is more sophisticated than this. Don't trade on such information!

¹ <https://www.investopedia.com/terms/e/etf.asp>

Applying Second-Order Thinking in your Trading

Whether you are designing market prudent or behaviour strategies, you need to ask yourself, has your market inefficiency been priced in.

This is easier for market prudent strategies. With a clear market inefficiency, we can implement second-order thinking by thinking from first-principles.

Market Prudent Strategies and First Principles

To think from first principles means to question your decision until you reach the base rationale/assumption.

For example, I want to short bitcoin because China is banning cryptos.

Why? Because crypto will fall due to lesser demand.

Why? Because it hasn't fallen yet and the news is not priced in.

Why? Because the news of the China crypto ban hasn't reached outside of Asia, and this piece of news is unexpected.

Why? Because I read the news on Weibo (China's version on Twitter) by reputable posters just seconds ago. (This will be the first principle)

Remember, you are checking if you're thinking differently from and/or faster than others, and that you're correct.

Behavioural Strategies

Implementing second-order thinking in behaviour strategies is tricky. We rely a lot on our backtests and optimisations. Questioning our underlying rationale will lead us somewhere, but not far enough. At the end of the day, we are trusting what our numbers tell us.

In order to increase the reliability of our strategies, we use a method called sandboxing. This means to market-hedge or time-hedge our strategies. We will talk about this in a future lecture.

P.s. Legendary hedge fund manager Howard Marks of Oaktree Capital emphasised second-order thinking (he calls it second-level thinking) in his book "The Most Important Thing: Uncommon Sense for the Thoughtful Investor". This is a book on investing, not algorithmic trading. It is worth a read.